COMPETITION COMMISSION

STANSTED QUINQUENNIAL REVIEW

Summary of a hearing with the Stansted Airport Consultative Committee
5 June 2008

The SACC and relationships with BAA

1. The SACC said that it represented many airlines with different business models. Membership was open to any airline operating at Stansted, and all the Stansted airlines were copied in, and consulted, on whatever the SACC said. If no consensus was reached, the SACC took no view. Most of the day-to-day work, however, was undertaken by Ryanair and easyJet. Some of the members of the SACC might recently have been slightly less productive than in the past, perhaps because the SACC's meetings with BAA had been unproductive, leading to frustration.

2. BAA had repeatedly accused Ryanair and easyJet of attempting to block development at Stansted, attempting to undermine the SACC, but none of the airlines, and especially not Ryanair and easyJet, were trying to block the development of the airport. The SACC had consistently supported a second runway and second terminal at Stansted, if done on a cost-effective basis and in conjunction with the airline users who were expected to underwrite it. Ryanair and easyJet had around 200 aircraft on order for delivery over the next four to five years, and would like to place many of those aircraft at Stansted.

3. Relationships with BAA had deteriorated over the previous three years, from a level which had not been good initially, due to both lack of information and misinformation from BAA. The development at Stansted which BAA was suggesting was positive to the supplier, but negative to its customers. It was inappropriate that if BAA began work on SG2, the prices to its customers would increase over the entire business volume. It was in the interests of BAA, as a regulated monopoly, to spend as much as possible. The situation had deteriorated since Ferrovial had taken over BAA, as Ferrovial had had the impression that all it needed to do was spend money on infrastructure and it would receive a rate of return on it. This was not the situation at airports with competitive constraints, such as Liverpool.

4. BAA had no incentive to find out from its customers what they needed so as to continue to grow. The key issue was the regulatory system; this caused the distortion, and that was why the SACC had not been able to discuss these matters with BAA, as it would expect to do at a competitive airport.

Constructive Engagement and regulation

5. Following BAA's delaying tactics and refusal to provide information, the SACC had expected that the CAA would step in and apply some regulatory pressure. Whether or not this had been done, no result had been achieved. For example, on security rosters, the CAA had eventually responded that BAA had agreed to discuss its methodology with the SACC; however, the SACC did not want to discuss methodology, but had wanted to know the numbers. The SACC found both the regulatory regime and the way in which the CAA carried out its duties very frustrating.

6. Gatwick had a wider range of different airline models, and the experience of constructive engagement had been quite positive when it was going on, but it was extremely disappointing that £400–500 million of extra capital expenditure was requested by BAA after the reference had arrived at the CC. The operating

expenditure increases after the CC's report had been submitted in November were similarly disappointing. There were, however, two reasons why the situation at Stansted was more extreme than at Gatwick. Firstly, the CAA had never acknowledged that Stansted had market power, and secondly, the only sanction for a failure of constructive engagement was that the building block approach would be used. The CAA's building block approach normally produced results which were very favourable to BAA. The CAA had maintained that there was no problem at Stansted, though BAA had doubled its charges at the airport in 2007, and had increased them again by eight to ten per cent in the following year.

Stansted's status as a designated airport

7. The CAA had not undertaken the normal level of regulatory scrutiny at Stansted following its recognition that constructive engagement was failing in December 2005. It had evidently thought that Stansted would be de-designated. BAA was now pricing beyond the cap, while the CAA had proposed de-designation by the back door with its market-led and precautionary price caps. The CAA kept assuming that BAA faced competition from airports outside London, something that was clearly untrue.

8. The DfT, in deciding whether to de-designate, only needed to accept that each of the three conditions was currently met—and having done so, did not need to go further. However, it was an unfortunate consequence that the DfT had said that, 'at the moment', Stansted did not seem to have significant market power. This might also have been because the DfT felt it needed to give some support to the CAA. For its part BAA needed to forecast as much capital expenditure as possible, and it did not matter within a quinquennium whether it spent this money or not. It was probably reasonable to suppose that BAA wanted to lessen the influence of the two largest airlines placed on Stansted. There had been a scaling back of capital expenditure in the early part of Q4, and the subsequent acceleration towards the end of the quinquennium.

Capital expenditure at Stansted

9. A good example of gold plating at Stansted was the arrivals bay. The requirements for additional space for immigration and baggage reclaim could have been met with a simple building structure, instead of which, BAA had to build a complete terminal bay costing £60 million. It should have been possible for BAA to meet the user need for £20 million. The arrivals bay had been in the Q4 capex programme, though neither the CAA nor the CC had scrutinized the capex programme in any detail. The documentation which existed from the Q4 review was very poor. However, BAA had argued that certain projects in that documentation were no longer necessary.

10. Another example of gold-plating was the preliminary expenditure on SG2. Much of this expenditure had been unnecessary, and £50 million had been spent on consultants with no reports produced. This seemed an even more blatant example of gold-plating than the arrivals bay. At Gatwick, BAA had recently attempted to review its capital expenditure programme and to decide whether capacity-enhancing programmes needed to be delivered. The proposed CAPEX trigger for the Pier 7 project at Gatwick was now referred to as 'additional pier service' so it was possible that the pier would not be delivered, though BAA had been allowed a return on the cost in the Q5 review.

11. The Arrivals and the Departures Bays were both good examples of gold plating. The Arrivals Bay was concerned with how to provide more capacity for immigration and baggage reclaim in a cost-effective way. The planning permission for the more

expensive option had been used as a justification by BAA. The Departure Bay was no longer justified against current capacity predictions, so BAA now planned to use it for commercial purposes, which would be a poor use of capital.

12. The SACC could not think of any examples where it had influenced BAA's projects. How the B-list projects converted into capital expenditure projections was not transparent at all. BAA head office apparently allowed the airport management little discretion. At Gatwick, airlines had at one point asked why £230 million of small projects had been included in the CIP, and the initial answer had been that that was what was required for the RAB. BAA had refused to give the SACC a business plan, saying that the CIP should suffice. BAA had said that there was no central business plan of the kind the airlines wanted, but then said that there was a plan but it was confidential. BAA had never been able to justify its forecasts.

13. The CAA stated in May 2006 that it had said in 2003 the basis for consultation would be on BAA's annual CIP. This had not been the case; what it had actually said in Annex 4 to its 2003 decision on airport charges was that the basis for consultation would be on BAA's business plan. This was a good example of why the SACC was frustrated with the CAA. BAA's long haul forecasts seemed unrealistic but were being used to justify expenditure on facilities for large, wide-bodied aircraft.

14. The decrease in the estimated costs for SG2 might have been strategic. BAA had originally proposed a ridiculously large number and had now reduced it. Since it had never seriously engaged with users on what users required, any proposal of BAA's must be in serious doubt. BAA's website said that it had consulted various parties, but not that it had taken into account the views of the airlines at Stansted. On the airlines' version of an Option D second runway, the CAA had had to tell BAA to talk to the airlines. BAA had subsequently ended discussion unilaterally, having highlighted some issues, saying that the SACC's option would not work. Airlines did not have the resources to put down a fully worked up proposal in the same detail as BAA's, but BAA, when it did so, should do so in accordance with its users' requirements, which it had not done. BAA's proposals for the new terminal were difficult to evaluate, however, since they contained nothing about the internal layout. The size of the footprint, however, did not suggest that the terminal was a low-cost option. It was ironic, however, that BAA had looked at low-cost terminals in the USA, but not on the Continent, though there were plenty of examples, such as Marseilles. The Stansted users would still welcome the opportunity to engage with BAA on these issues.

Stansted's competitive position

15. As the five London airports were full, or nearly so, there was no option for Stansted airlines but to continue with Stansted. Going to East Midlands to serve the London market was not an option. Neither that airport nor Southampton served the London market. Frontier Economics' analysis had shown that in order to move Stansted passengers to East Midlands the airlines would have to pay the passengers to fly, perhaps £20–30 per passenger. London City was too small for the aircraft used by the LCCs and Luton was full at the peaks. If the CAA announced a price cap of £12.50, Stansted would attempt to price up to this cap. Airlines would not then base aircraft of which they were about to take delivery at Stansted, and as a last resort would cut services to the London area. If there were separate ownership and significant spare capacity, it might be that the London airports would seek to compete for airline custom, though this was unlikely to happen in the immediate future. A separately owned airport would be likely to have discussions with airlines before it developed capacity, to ensure that it could fill that capacity. So a break-up of BAA might trigger competition at the individual airport level, possibly engendering

competition in the medium term. Separate ownership would place an incentive on airports to deliver cost-efficient capacity which was not there at the moment.

Terminal development tendering

16. The SACC did not know whether terminal development tendering (TDT) could be imposed on BAA. The CAA often lobbied for the law to be changed when it thought that it should be. This approach would place an incentive on BAA to plan an efficient second runway because it would stand to gain by the traffic generated over that runway. The TDT approach for the new terminal and the building block approach on the existing assets were two halves of the same thing. It would be perfectly possible to set a building block price cap for Q5, and also put TDT in place. The price cap at the start of Q5 would simply need to identify what applied to the access infrastructure and what applied to the facilities infrastructure. The tender process would not have to be completed before the CC's recommendations were finalized. Even if this approach were adopted, the CC would still have to set most of the Q5 price cap.

17. esayJet, the author of the TDT proposal, had no view on where the new terminal should go. A master plan should identify a number of possible locations, taking users' views into account. With TDT, there would be stronger incentives on BAA to engage with users to find the most efficient approach. The master plan would require regulatory oversight. The CAA, however, did not currently appear to have much appetite for this role. It had not even done the work to set a forward-looking building block price cap. Allowing competition between the two terminals would reduce the need for regulatory oversight of service standards if there were spare capacity. Certain features of the new terminal, such as the location of taxiways, might have to be specified in advance, though the tender could be at a fairly low level of detail. The best value tender, as required by users, should be chosen, subject to a certain capacity criterion. Running the tender process did not seem as difficult as the CAA had argued. The interface between the owner of the runways and competing terminals did not seem to be an issue. The runways were operated by NATS. The Slot Allocation Regulation and NATS between them would prevent BAA from discriminating between aircraft.

18. The situation at Dublin was exactly the same as at Stansted. The Irish Government had retained the existing monopoly for building the facility. An independent study had identified several benefits from terminal competition, though the Dublin Airport Authority would have retained the ownership of the runway. Existing legislation would have ensured no competition problems. However, union pressure had ensured that there was no competition at the airport. The Government's decision had, however, held out the possibility for competition if a third terminal were required.

19. There might be an issue with the planning process in obtaining approval for a second runway. This might mean that the runway price would require regulation for the time being to ensure that the runway could be delivered. The master plan was the most important component of the process. Airports which built low-cost terminals, such as Marseilles, were often subject to pressure from outside the airport. There might be additional complexities once the new terminal came into operation, but the airlines would accept this short-term pain to obtain the long-term benefit of competing terminals. Any price cap, however, needed to be tight, and there was also the issue of how additional facilities were included. If there were a market for additional capacity, the airport should be able to build it, perhaps even negotiating a more expensive facility which would meet the needs of certain users, but this investment should be undertaken at the airport's risk. It would be very useful to have a separate price cap for the operation of the runway in order to allow TDT to be inserted later. The date by which additional runway capacity was required was probably somewhat

later than previously thought, though the new terminal capacity might be developed earlier.

Prefunding and pre-approval of capital expenditure

20. The SACC did not understand why prices should increase sharply when new capacity was being developed. It was not clear that spending large amounts of money in a lump sum should produce a sudden increase in prices. There were several ways of spreading the sum incurred over the life of an asset. It might be possible to implement passenger weighted depreciation. It did not seem appropriate, however, that airlines should pay for assets in the course of construction. If they did not, a sudden increase in prices would be less of a problem. TDT would avoid a price spike because the new operator would be competing with BAA. The airlines should not be faced with a spike simply because new capacity came on stream. When the airlines bought a new plane, they filled it up through offering a competitive price.

21. Pre-approval of capital expenditure before inclusion in the RAB was a good idea, though it had some problems, such as the voting system to be used. It might be appropriate to set up principles to be met before capital expenditure was allowed, such as that the investment should be net present value positive to users in aggregate. It might not be problematic, however, since nearly all the airlines at Stansted were point-to-point, and these airlines had similar needs. However, only those users who required elaborate facilities, such as those for A380s, should be required to pay for them. The SACC's position on the structure of the price control was that it supported a tight building block price cap to be followed by the implementation of TDT. The SACC was arguing for removing items from the RAB because they were either not required or over specified.

Operating expenditure

22. The best value for security might be achieved through a competitive tendering process with strict service level agreements. It was likely that private security firms could provide this service better than BAA. Airlines were not concerned whether a private security firm or BAA provided this service, but it should be at the right service level and at the right price. It was not correct to claim that the service at Stansted was improving, as the winter was not as busy. Stansted was the worst-performing airport to which Ryanair operated in the UK. The SACC would welcome more transparency on the boundaries between regulated and non-regulated charges. Non-regulated charges were increasing above the level anticipated when the previous price cap had been set. It appeared that BAA had recovered the cost of providing the facilities for the fuel levy several times over. It was not acceptable that BAA might be able to charge a portion of those facilities as part of the price control.

23. There was a need for an effective service quality scheme at Stansted. It should probably not incorporate bonuses. Exposing around 5 to 10 per cent of revenue seemed about right. It would be preferable to have service quality measurements more automated and quantitative. It might be appropriate for the sums at risk to be set, and then for users to determine what measures were most important to them. Broadly, it appeared appropriate to include in the regime some measurement of security queues and of facilities such as lifts.

24. Any opportunity for additional competition should be taken. This might involve either the introduction of competition between terminals or the break-up of BAA. Ryanair would eventually like to see the break-up of BAA. This would be the only way to improve the situation once additional capacity came online. Concerning the

regulatory framework, the CAA did not appear to be applying its statutory duties in a balanced way.